First National City Bank
Monthly Letter

Business and Economic Conditions

1959

New York, July, 1959

General Business Conditions

THE threatened steel strike has been postponed for at least two weeks, as the companies and union accepted President Eisenhower's suggestion that they "continue to bargain without interruption until all of the terms and conditions of a new contract are agreed upon." The extension of the old contract through July 14 was agreed to on June 27 as mills were beginning to cool their furnaces.

The steel wage negotiations have been under way for two months already. Skeptics may doubt that another two weeks will reconcile the differences. But no one really wants a strike. And the two months' negotiations have served to impress upon the union – and the public at large – the firmness of the resistance of the companies to more wage-price spiraling.

The steel industry is having a good year and it would seem to the casual observer that the companies should be willing to negotiate a generous settlement. But a wage contract runs for an extended period. The last one required wage boosts in a depressed year, 1958. American steel wages are among the highest in U.S. industry, and far and away the highest steel wages in the world. The competitive power of our exports is at stake, as well as the confidence of the world in the dollar. Foreign observers, who fear that our economy may be caught in a nonstop inflationary cycle, look to the steel settlement, along with the federal budget, federal debt management, and monetary policy, as a significant test of our determination and ability to resist inflationary pressures.

It should be understood that the issue in the steel case is not solely whether steel prices rise. The effect of an inflationary steel wage pattern on other wages, spreading through the industries and stepping up costs everywhere, is the greater danger. Important contracts in copper, aluminum, rubber, and meat packing are now up for negotiation. The fresh impulse that a substantial boost in steel wages would give to inflationary pressures from the side of employment costs is the chief worry, shared throughout the business community and also among responsible leaders in government.

Wage Patterns of 1959

President Eisenhower, though opposing direct government intervention, has repeatedly warned both sides of the dangers of an agreement which might greatly aggravate the spiral of wage and price increases. This spiral was not halted even by the recession. During the nine months of business contraction, industrial wages rose on the average by 4 cents per hour. Since the beginning of the upturn in April 1958 they have risen another 12 cents.

During the first quarter of this year, the pattern of wage increases clustered around 7 to 9 cents per hour, according to the tabulations by the U.S. Bureau of Labor Statistics. However, 37 per cent of the workers won boosts of 11 cents

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or more. Particularly substantial wage increases have occurred this spring in construction—an industry booming in many areas. *Engineering News-Record* reports that recent wage contracts in building trades provide average increases of over 14 cents per hour in 1959 plus deferred increases averaging 11.5 cents in 1960. These raises are on top of wage levels which are already high.

Steelworkers' earnings averaged $3.10 per hour in April. Among factory workers only flat glass employes averaged more. Before the negotiations began, David McDonald, president of the United Steelworkers, made it clear that the union aimed to get the largest increase in wages and fringe benefits in the union's history, and a widespread union advertising campaign implied that steelworkers were seeking a settlement which would give them a billion dollars more to spend.

The steel companies have been adamant on resisting further additions to employment costs. In June, they suggested that if the union agreed to certain changes in working rules, the savings thus generated might provide the means for future wage increases. The union summarily rejected this proposal.

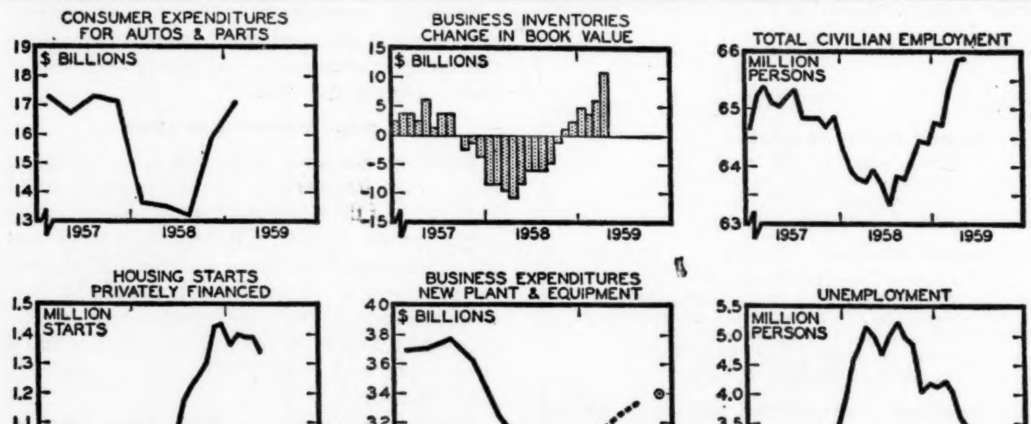
One point figuring in the steel wage negotiations is the idea that, since a wage spiral seems already under way, the steelworkers should get their share. On the other side is the tremendous importance of steel as a pattern-setter. If wage-price spiraling is to be arrested, a major industry must set the example.

Another point made by the union is the growth of productivity in the industry. Yet this has been the fruit of large capital investment in more efficient equipment directed at saving labor costs. If wages consume the gain, the saving in labor costs is wiped out, and nothing is left as a return on added capital investment. There will be more job opportunities in the high-paid steel industry if the companies can hold down prices and compete more effectively with foreign producers and substitute materials.

The Inventory Build-Up

Ever since January, steel users have been building inventories as protection against a possible strike. The record-breaking 65 million tons of steel ingots and castings produced during the first half of 1959 was not only sufficient to supply the steadily rising activity in heavy industries, but also to nearly double stocks of raw and semi-finished steel in the hands of users. Steel inventories at midyear are estimated at the equivalent of 20 to 22 million ingot tons—roughly two months' production. If the industry achieves a peaceful settlement, a greater than usual summer letup in steel activity is indicated as these stocks are worked down.

Such a letup would amount to no more than a surface distortion in an expanding economy. A steel strike, on the other hand, would cause hasty, unbalanced inventory liquidation. However, the strikes we have had, as in 1952 and 1956, have not been so paralyzing as popularly supposed: over-all production dipped less than 5 per cent from prestrike highs. After each of the strikes, the economy rebounded swiftly. New production records were set within a few months. In the present situation the forces which have pushed the economy to its present high



Major Forces in Recession and Recovery

(All series seasonally adjusted; all except employment and unemployment at annual rates.)

level appear too strong to be reversed either by a strike or by orderly liquidation of excess steel stocks.

Prosperity Moving Toward Boom

Recently President Eisenhower described the business situation as "prosperity that looks like it is assuming boom proportions." Few would argue with that description. Early this year, high unemployment and the faltering of some economic indicators raised doubts as to the strength of the upturn. Recovery has since become accomplished fact, and the upward movement has continued vigorous. The charts on the preceding page illustrate the momentum of the upsurge.

The most dramatic part of the upswing has been the shift from inventory liquidation to accumulation. In April (the latest month available) business firms added $900 million to the book value of their inventories — equivalent to an annual rate of more than $10 billion. Only a year earlier, liquidation was proceeding at an equally rapid rate. Clearly, such rates of liquidation or buildup are not sustainable over a long period, nor are they expected to persist this time. Slackening or reversal of the accumulation of steel in the hands of fabricators, and passenger cars in the hands of dealers —which together may have accounted for as much as half of the April buildup — will reduce the over-all rate of inventory growth during the third quarter.

Yet there is room for further increases in business stocks in many lines. Between the low point on October 31, 1958 and the end of April, manufacturers, wholesalers, and retailers added $2.4 billion to their stocks, but the total was still $4 billion below the pre-recession peak. Meanwhile, business sales rose $2.6 billion above their pre-recession peak. In other words, businessmen did 4 per cent more business with 4 per cent less on the shelf. Merely to bring stocks into line with the current level of sales by restoring the average stock-sales relationship of the past decade would require an additional buildup of $7 billion.

Factors in the Upswing

Inventories, of course, have not been the only factors in the upswing. A strong improvement has been apparent in consumer demand, bolstered by higher employment, record incomes, and a revival of heavy instalment buying. Especially noteworthy has been the sustained high rate of home building and the strength of consumer demand for automobiles, despite announcements that new compact cars will be introduced in the fall.

Following the usual cyclical pattern, one of the slower sectors to recover has been business expenditures on new plant and equipment, which by the first quarter of this year had regained only one eighth of the recession decline. Rising sales and a sharply increased cash flow from depreciation and retained earnings have increased management interest in modernization of facilities, and, to a lesser extent, in expansion. Recent surveys of capital appropriations, new orders, and contracts placed all point to a sustained rise in investment extending into 1960. A survey by the Securities and Exchange Commission and the Department of Commerce in May indicated that business spending on new plant and equipment would reach $32.6 billion during 1959, an increase of 7 per cent over 1958; three months earlier, business had planned to boost spending by only 4 per cent.

Disciplined Prosperity

The strong and nearly unanimous advance in activity during the first half of 1959 has led to widespread expectation that the upsurge will continue. The momentum for a renewed rise, once a steel settlement is reached, is certainly there, but the advance is unlikely to be so steep. While inventory accumulation will go on, the extra stimulus which comes with moving from liquidation to accumulation will be missing in the year ahead. Instead of the $13 billion pumped into the economy by the fiscal 1959 federal deficit there will be a more nearly balanced budget. There is still room before we reach the limits of manpower, materials, and industrial capacity, but each advance carries closer to those limits.

Risks of price inflation reside in every period of business expansion. It was not many months ago that criticisms were being heard of the President for advocating a balanced budget and of the Federal Reserve System for permitting credit to tighten. It now becomes clear that these represented reasoned and correct appraisals of the developing situation. Symptomatically, the consumer price index is tending to probe into new high ground. It is time to recognize, as reserves of idle resources are drawn down, that there is need for restraint all around to keep excesses of spending power from fostering another wage-price spiral which may be difficult to control and impossible to halt without a painful shake-out.

Speaking before the New York State Bankers Association last week, Raymond J. Saulnier, Chairman of the President's Council of Economic Advisers, pointed out: "Present labor costs have been rising at a rate not unlike increases in periods in which we have had either price in-

creases or a substantial squeeze on profits." These alternatives are equally unacceptable. Price spiraling can give us a boom leading to inevitable collapse; a squeeze on profits will lead directly into contraction in capital outlays of business and in business activity in general.

The critical needs are for restraint: on the part of organized labor in seeking bigger wages and fringe benefits, on the part of business in advancing prices, on the part of government in programming expenditures, and on the part of the Federal Reserve in adding to the monetary base.

Interest Rates on U.S. Bonds

On June 8 President Eisenhower sent to Congress a special message dealing with urgent public debt matters. He requested: (1) elimination of the 4¼ per cent legal limit on rates the Treasury may pay on new bond issues; (2) elimination also of a special 3.26 per cent limit applicable to Savings bonds; and (3) increase in the public debt limit, mainly to permit borrowings in the first half of the new fiscal year (when revenues are low) for repayment in the second half (when revenues are high).

While the authority to borrow more sped through the legislative chambers, the authority to pay higher rates on bonds met resistance which delayed action. The 4¼ per cent rate limit on new Treasury bonds has been in force since 1918, when it was incorporated in the Third Liberty Bond Act. Noting this fact, Senate Majority Leader Lyndon B. Johnson called for study of "every possible alternative to changing a law that has been working for forty years," and asserted that Congress must "stop, look and listen before countenancing an increase in the cost of money to the Government."

It is, indeed, a good time for the Congress to review the situation and to apprise itself of how fiscal policies have added to demands for borrowed money while discouraging investment interest in U.S. bonds. The facts were laid out in the President's statement and, at greater length, in statements Secretary of the Treasury Robert B. Anderson submitted to Congress.

Flagging Interest in Savings Bonds

For many months now the Savings bond program has been faltering. Redemptions have been running ahead of new sales, adding to the already excessive needs of the Treasury to borrow in the open market. There is no doubt that more attractive rates would bolster public interest in these securities.

The President disclosed that, with the limits removed, the rates on the Series E and H Savings bonds would be advanced to 3¾ per cent effective June 1, 1959. To encourage continued holding, the increase would be applied to old bonds as well as to those sold since June 1.

What has happened to Savings bonds is symptomatic of what has been happening to interest in U.S. bond investment generally. People have been seeking higher returns, for shorter periods in savings institutions, for longer periods in common stock investments. An earlier increase could have helped finance the record fiscal '59 deficit as well as counteract inflation fears growing out of that deficit. But it is better now than never and better too that the Treasury be given authority to adjust the rate in a timely fashion up or down as future conditions warrant.

The Savings bond program amounts to a kind of savings account facility. The bonds are redeemable on demand. The holder assumes no risk of market price depreciation.

The Treasury has to pay higher rates on regular marketable bonds where there are no redemption privileges and the investor has to depend on what he can get in the market if he wishes to cash in prior to maturity. As many holders know, the losses can be quite serious.

The 4¼ Per Cent Bond Limit

It is not always clearly understood that the Treasury sells four types of obligations in the open market. On three of them there are no statutory rate limits: Treasury bills and certificates, which run for terms up to one year, and Treasury notes, which run up to five years. Absence of limits is a practical necessity. If the Treasury were limited in the rate, it might be forced to default on obligations for lack of ability to borrow. Within this century the Treasury has paid up to 6 per cent for short-term money.

Bonds, subject to a 4¼ per cent limit, are the only class of U.S. obligations which can have a maturity beyond five years. Under present-day conditions the practical effect of the 4¼ per cent bond rate limit is to repress offerings of long-term bonds and to compel the Treasury to finance by the sale of obligations due within five years. Since exclusive reliance on short-term financing is inflationary, the effect of the limit is to create concern, at home and abroad, over the future value of the dollar.

The highest coupon rate the Treasury has paid on bonds in recent years is 4 per cent. One 4 per cent issue due in 1980 was put out in January at a price of 99 to give the buyer a yield to

maturity of 4.07 per cent. Since then, with pressures of increased credit demands, these bonds have traded below 97 and it is believed in the market that a rate around 4½ per cent might be required to place more long-term Treasuries at this time.

The highest cost of money to the Treasury in recent years was 4.17 per cent on a special issue of Treasury bills put out in August 1957.

The short-term rates free from statutory limits have fluctuated widely. On 91-day Treasury bills, sold at auction in a free market, the rate approached 2½ per cent in 1953, dropped as low as ⅝ per cent in the 1954 business recession, rose above 3½ per cent in the 1955-57 boom, retreated to ⅝ per cent again in the 1958 recession and recently moved back up above 3 per cent. As Secretary of the Treasury Anderson pointed out, removal of the limit on bonds would not necessarily mean higher average borrowing costs. Interest rates are related to credit demands, including the size of government deficits. If bonds cannot be sold, the upward pressure on short-term rates becomes more acute.

One very practical reason for lifting the 4¼ per cent bond rate limit is the developing pressure in the short-term market. The $5 billion long-dated Treasury bills scheduled for sale this month, to finance the bulk of the July-September deficit, will raise the outstanding total of Treasury bills to a record $37 billion. Outstanding bills due next April are trading in the market to yield above 4 per cent. Too much reliance on short-term finance risks supersaturation of demands and creates a jumpy market. Higher rates have enlarged the market among corporations and foreign accounts but these will not be willing and able to add to holdings indefinitely.

It is better to have access to all market areas and — most vitally — the long-term area where bonds can be put away in the box for years.

Competition for Borrowed Money

The President based his recommendation for elimination of the interest rate limit on the simple fact that the Treasury needs to be free to compete on equal terms with other borrowers for the available supply of long-term savings:

> Market yields on a number of Treasury bonds are already above 4¼ per cent. With one exception all bonds which have five years or more to run to maturity have market yields above 4 per cent. The Treasury recently has done substantial short-term borrowing. But it must avoid undue shortening of the public debt and therefore should continue to sell intermediate and longer-term bonds whenever market conditions permit. It should not be prohibited from doing so by the existence of an artificial ceiling which under today's conditions makes it virtually impossible to sell bonds in the competitive market.

In his statements the Secretary of the Treasury explained the sources of competition for borrowed money. In trying to place long-term bonds the Treasury must compete with business, State and local governmental bodies, and home mortgage programs, including those aided by Federal Government guaranties and insurance. He pointed out how savings institutions have been tending to reduce the proportions of their funds in U.S. obligations while continuance of high income taxes has led individuals increasingly to seek tax-exempt income on municipals and capital gains on common stocks. But "the major factor," the Secretary said, "contributing to the rise in interest rates during the past year has been the $13 billion Federal deficit":

> It has exerted a twofold impact: first, by stimulating expectations in the summer of 1958 of strong credit demands and of a further erosion in the value of the dollar; and, second, by adding . . . to the demand side of credit markets.

Congestion of Short-Terms

The question naturally arises as to why, since the budget is now swinging toward a balance, the Treasury needs to put out long-term bonds. One answer to this question is that, while the debt will be with us for a long time, very little now is in long-term form. A second answer is that, with the passage of time, long-term debt gets shorter so that short-term debt piles up.

As the debt comes closer to maturity it becomes more nearly the equivalent of cash. And there is nothing to prevent the holder from insisting on cash at maturity, however straitened the Treasury's position may be. Debt due within one year, described by the Secretary as "only one step away from money," will amount to $78 billion on July 15 and will rise to almost $100 billion by December 1960 if new offerings should be restricted to the one-year category.

The suggestion has been made that the Treasury go out as far as it can, sell five-year notes and pay the rate required. Unfortunately this is the most congested area of the market where money costs are highest. The principal buyers in this maturity range are commercial banks which are not in a position to increase U.S. security holdings but rather — as the depressed market shows — are reducing them to make room for added loans to business, home builders, and consumers. The investment market is further out, requiring bond issues of at least ten years' term.

Perspective on Rates

As Reserve Board Chairman William McChesney Martin observed in testifying before the House Ways and Means Committee, current interest rates are moderate when viewed in the historical perspective. Explaining rising rates, he noted that they are "a symptom of broad prosperity and rapid economic growth."

A second explanation is the record of twenty years' depreciation in the dollar.

A third explanation is taxation of interest income. As the Secretary of the Treasury pointed out, "the original 4¼ per cent rate was in large part a tax-exempt rate, whereas all Treasury bonds issued since February 1941 have been fully taxable — and at income tax rates that are substantially higher than in 1918."

When corrected for taxation of interest income, and deductibility of interest expense, interest rates remain at historically depressed levels. To individuals in high brackets, taxable interest income — or interest expense — are of no more than nominal importance. To a corporation taxed at 52 per cent, effective interest rates are half what they seem to be.

Apart from these essential aspects, the 4¼ per cent limit survived for more than forty years out of a sequence of unusual circumstances. It might have been breached in 1920, when yields on outstanding Treasury bonds rose as high as 6.60 per cent, but a string of 11 successive federal budget surpluses avoided need for new bond issues at times of pressure. There was no worry over a shrinkage of the dollar; the income tax consideration was of minor significance.

The low interest rates of the 1930's were due to the Great Depression, which brought reduced credit demands and cheap money policies. In World War II interest rates were pegged at low levels by the Federal Reserve to assist war financing, while demands for credit from State and local governments, businesses and individuals were reduced to a minimum by rationing and other controls.

The postwar boom brought increased spending and private borrowing to a point requiring restraint of credit and encouragement of savings. Attempting to deal with inflationary pressures by raising bank reserve requirements, the Federal Reserve succeeded only in demoralizing the bond market. With gold moving abroad, the Federal Reserve in 1951 finally gave up on trying to keep 2½ per cent bonds above par. The pegs were giving bondholders a chance to realize cash; they afforded no foundation for Treasury bond offerings.

Other countries sooner or later learned the same lesson, which is, in effect, that printing money to keep interest rates down discourages people from saving, whets appetites to borrow, and creates distrust in the promises of government. Ironically, the highest rates of interest on record have emerged in countries which, trying to keep interest rates down by artificial means, have set loose the wild horses of uncontrolled inflation.

Search for Alternatives

The President warned emphatically against schemes designed to lower interest rates artificially:

> I am aware of the fact that many proposals have been made which are designed to produce lower interest rates. However, any debt management device which would seek to interfere with the natural interaction of the competitive forces of our free economy and produce unnatural reductions in interest rates would not only breach the fundamental principles of the free market, but under current conditions could be drastically inflationary. The additional cost to the Government alone from increased prices of the goods and services it must buy might far exceed any interest saving. The ultimate harm to the entire nation of such a price rise could be incalculable.

Despite the President's warning, Congressional debate on the proposal to eliminate the 4¼ per cent rate ceiling quickly veered off into well-worn paths of how to get and keep interest rates at arbitrarily low levels. Study was launched of possible alternatives to removing the bond rate limits. One most obvious alternative — offering income tax exemptions — received scant consideration. While borrowing costs could be lowered, the Treasury would lose revenue; it would cease to get back in taxes — as is now the case — a large part of the interest paid out. Also, the market for State and local obligations, which now exclusively enjoy exemption from federal income tax, would be hurt.

Another way of avoiding change in the rate limit would be to sell bonds at discounts below par so as to afford the buyer yields higher than nominal coupons. For many investors bonds at a discount would be an acceptable solution; for others, desirous of maximizing current income and minimizing tax accounting, a higher coupon rate would be preferred.

Further thoughts were to remove the limit only for obligations due within 8 or 10 years, or to suspend the limit only for a specified time or on a specified amount. These alternatives, of course, would not meet the objective of giving the Treasury continuing and full access to the long-term investment market.

In the debate it was amazing to hear the argument that high interest rates are inflationary be-

cause they are a cost of doing business and must be covered in selling prices. As a cost of doing business, interest is a comparatively minor item. But the vital point is that interest rates rise when lenders have more requests for credit than they can handle and borrowers are being asked and required to curtail their spending plans. In other words, rising interest rates are symptomatic of a check on spending as well as an encouragement to saving.

Federal Reserve Support

Nevertheless, Congress was tempted by the idea that an increase in the 4¼ per cent limit on bonds could be avoided by having the Federal Reserve Banks provide price support. Congressman Wright Patman took the occasion to revive his proposals that the Federal Reserve Banks should go back into the business of pegging government bond prices and standing ready to buy at par all government bonds. This idea, repudiated out of past experience, could make the entire public debt the equivalent of interest-bearing cash, in effect adding another $285 billion to the nation's money supply. It is impossible to conceive of any scheme more likely to destroy faith in the dollar.

The indictment of the pegging practice lies in the Congressional archives in the report of the Douglas Committee in 1950 which states:

> The vigorous use of a restrictive monetary policy as an anti-inflation measure has been inhibited since the war by considerations relating to holding down the yields and supporting the prices of United States Government securities. As a long-run matter, we favor interest rates as low as they can be without inducing inflation for low interest rates stimulate capital investment.
>
> But we believe that the advantages of avoiding inflation are so great and that a restrictive monetary policy can contribute so much to this end that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be a significant increase in service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes.

While sticking to the basic principle, Senator Douglas in the present instance has suggested that the Federal Reserve Banks might support prices of long-term Treasury bonds, offsetting bond purchases by sales of short-dated Treasury bills, certificates, and notes. This procedure could neutralize the money-creating effect of bond purchases. But it would be inflationary in the sense that holders of long-dated bonds would get the chance to free their funds while market supplies of short-dated debt would be increased and thus the market's near-term claims upon the Treasury for cash. There is little constructive achievement in loading up the central banking system with long-term bonds. When Federal Reserve buying power was exhausted the market would be ready for collapse. The problem is not to reduce public holdings of U.S. bonds but to enlarge them by periodic new offerings at rates acceptable in an unsupported market.

Federal Reserve Board Chairman Martin, in testimony before the House Ways and Means Committee, vigorously rejected the demands that the Federal Reserve keep interest rates low. He warned that: "This cannot be done without promoting inflation — indeed without converting the Federal Reserve System into an engine of inflation." Pointing out that the war and postwar pegging of government security prices and yields succeeded only at the cost of "dangerous bank credit and monetary expansion" and "a very rapid depreciation of the dollar," he observed:

> The trouble is that the world has learned from wartime inflationary experience. It now knows that inflation follows any effort to keep interest rates low through money creation as the night follows the day. Any attempt on the part of the Federal Reserve to peg rates today would be shortly followed by an acceleration of the outflow of gold in response to demands from abroad, by further diversion of savings from investment in bonds and other fixed interest obligations into stocks and other equities, and by a mounting of demands for borrowed funds in order to speculate in equities and to beat the higher costs and prices anticipated in the future.

Stable Rates or Stable Prices

A number of Congressmen made the point that the consumer price index has been remarkably stable in the past year and that the only "inflation" has been in interest rates. They drew the conclusion that restrictive Federal Reserve credit policies are not necessary. No one ventured to say that perhaps price stability shows the effectiveness of early Federal Reserve actions to counter inflation pressures.

The fact is that we face a choice between keeping interest rates stable or keeping prices and the economy stable. As Treasury Secretary Anderson told the Ways and Means Committee, the interest rate, speaking broadly, is the price of borrowed money. As prosperity makes business and individuals more willing to borrow money, the only way its price — the interest rate — can be held stable is by increasing the supply of money. The trouble with all schemes for increasing the supply of loan funds artificially — as by abusing the Federal Reserve's powers of money creation — is that total spending power is increased beyond the ability of the economy to supply goods at stable prices. Inflation follows.

Secretary Anderson gave the only sound prescription for lower interest rates in his statement to the Ways and Means Committee:

(a) Convert the Federal Government from a net borrower to a supplier of funds in credit markets by achieving a surplus in the budget during periods of high and rising business activity. A net surplus permits the Treasury to retire debt on balance; consequently, Government actions would result in a net supply of funds available for private borrowers, not a subtraction as is the case when the Federal Government borrows to finance a deficit.

(b) Convince investors that the value of the dollar will be protected, thus removing the pressures for higher interest rates stemming from a conviction that further inflation is likely to occur. . . . the most important single action would be a clear demonstration of the Government's determination to maintain fiscal and monetary discipline.

(c) Provide the Treasury with sufficient flexibility for sound management of the public debt so that a better balance in debt structure can be achieved – including larger amounts of longer-term securities outstanding – and so that bond markets will not become unsettled over such things as an impinging interest rate ceiling.

We have no real alternative to this approach if we want to face up to our problems in a manner consistent with our traditions of freedom, competition, and responsibility. In making its decision on the 4¼ per cent rate limit Congress should bear in mind that the eyes of the world are upon us.

As Reserve Board Chairman Martin told the Ways and Means Committee:

We need to remember that today the dollar is the anchor of international financial stability. That anchor must be solid. Realistic financial policies of Government are essential to that end as well as to the end of a wealthy and strong domestic economy. At this juncture of world development, the least evidence of an irresponsible attitude on the part of the United States toward its financial obligations or of its unwillingness to face squarely the issues which confront it in meeting greater demand pressures on resources and prices would have very serious repercussions throughout the free world.

Dwindling Export Surplus

Once again there is much comment, here as well as abroad, about the decline in the U.S. gold stock. Actually, the gold outflow so far this year has been very moderate if one considers the fact that foreign nations are acquiring dollars at a rate beyond $3 billion a year through their net transactions with the United States. Through June 25, they have converted $419 million into gold*, but have kept the bulk of their earnings in dollars, enlarging their short-term investments in the New York money market. The gold loss has been running much less than in 1958 when $1,425 million went out in the first six months and $2,247 million in the year as a whole.

*In addition, the United States paid in June $344 million in gold to the International Monetary Fund as part of the $1,375 million increase in its subscription; the remaining $1,031 million was paid in the form of non-interest-bearing demand notes.

The size of the gold outflow is less a matter of concern than developments in the balance of payments that give rise to a deficit of the present magnitude. There has been this year a further fall in merchandise exports and a continuing rise in imports. As a result, the export surplus has been cut to quite modest proportions. At the same time, the United States is supplying – through military expenditures abroad and governmental grants and loans as well as through private investments – many more dollars to the rest of the world than are being used abroad to finance our greatly reduced export surplus.

In the long run, the money we spend, lend, or invest abroad must be matched by exports of goods and services. Otherwise, the result of imbalance is an outflow of gold, from a substantial though not inexhaustible stock, or a further increase in U.S. short-term indebtedness to foreign countries.

Recent Export Performance

During the first four months of 1959, our merchandise exports (excluding those supplied under military aid programs) totaled $5.2 billion. They were thus running at an annual rate of $15.6 billion, which would be $0.7 billion below 1958 and $3.9 billion below 1957.

By far the largest drop has occurred in coal and coke, petroleum, steel and steel products, and nonferrous metals. Demand for these commodities, which had soared in early 1957 at the time of the Suez crisis and the investment boom in Europe, Canada, and Japan, dropped sharply with the passing of these unusual circumstances. However, the decline has persisted into 1959 – partly because of the glut of coal in Europe and partly because recovery from a mild recession there lagged behind the United States.

U.S. Exports by Commodities
(In Millions of Dollars)

	January - April			
	1956	1957	1958	1959
Coal and coke	$ 185	$ 262	$ 166	$ 119
Petroleum products	142	448	153	144e
Metals and manufactures	628	859	519	437
Subtotal	955	1,569	838	700
Cotton	140	453	288	125
Wheat, rice and other grains	355	516	391	453
Subtotal	495	969	679	578
Electrical apparatus	301	313	329	304
Industrial machinery	676	807	790	723
Passenger and commercial vehicles	321	286	222	196
Aircraft	282	327	332	232
Other machinery and vehicles	517	599	552	586
Subtotal	2,097	2,332	2,225	2,041
Textile products (excluding raw cotton)	218	247	227	199
Chemicals	406	464	445	474
All other exports	1,520	1,674	1,468	1,552
Total exports	$5,691	$7,255	$5,882	$5,544

e — estimated.

Source: U.S. Department of Commerce. Published monthly data include exports under military aid programs (about $400 million during January - April 1959).

Changes, and expectations of changes, in U.S. agricultural surplus disposal programs are another special factor that greatly affects our exports. Thus, foreign sales of U.S. cotton greatly expanded in late 1956 and in 1957 following a long-anticipated reduction in the U.S. export price. They declined considerably in 1958, and during the first four months of this year were running at less than one half the rate a year previous. Shipments of grain, on the other hand, recorded a large gain this year.

The decline in the few commodities that have been influenced by these special circumstances accounts for the bulk of the drop in our total exports in the last two years, as clearly appears from the table. Reductions in exports of other types of goods, however, have also been significant, for example vehicles, industrial machinery, and textile products. Indeed, the chemical group is the only major category of industrial products that shows an increase this year.

The business recession in other industrial countries, and lower export earnings of primary-producing countries, have been among the chief causes of the decline in our exports of manufactures. But the growing competition in world markets has also become an important factor in our export performance†.

Imports Topping all Records

Our merchandise imports, remarkably sustained during the business recession, have risen to an all-time high in the ensuing recovery. During January-April, they totaled $4.8 billion. The annual rate, $14.4 billion, would be $1.6 billion above 1958 and $1.4 billion above 1957. Finished manufactures during January-April of this year were fully 25 per cent above the comparable period of 1958.

U.S. Imports by Commodities

(In Millions of Dollars)

	January - April			
	1956	1957	1958	1959
Foodstuffs	$1,132	$1,150	$1,165	$1,146
Coffee	516	531	421	378
Crude materials	1,041	1,007	949	999
Petroleum	249	279	308	291
Rubber	175	122	91	119
Wool	104	91	62	86
Semimanufactures	977	1,022	868	1,060
Gas and fuel oil	141	192	195	236
Nonferrous metals	315	324	238	204
Iron and steel	20	21	17	52
Wood products	190	163	152	197
Finished manufactures	983	1,147	1,200	1,527
Passenger cars and parts	42	93	170	270
Machinery, other vehicles	152	178	179	231
Iron and steel manufactures	76	107	77	121
Textiles	145	147	149	163
Total imports	$4,133	$4,325	$4,177	$4,731

Source: U.S. Department of Commerce.

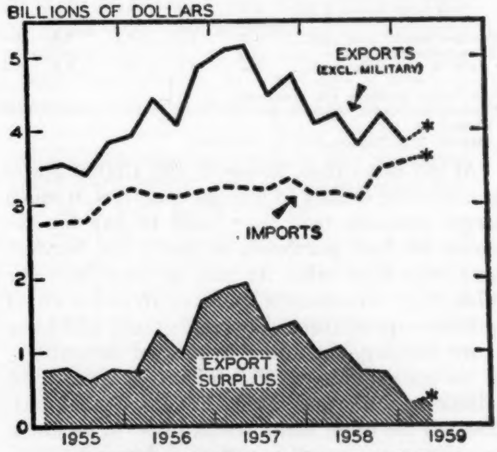
†See "U.S. Competitive Position in World Trade" in the March 1959 issue of this *Letter*.

While imports of foodstuffs have remained stationary this year, those of crude materials and semimanufactures have advanced as a result of growing output and inventory buildup here. A considerable part of this gain may be accounted for by the enlarged volume of fuel oil that entered the country prior to the imposition of mandatory import quotas early in March.

A particularly notable rise has occurred in machinery and vehicles. Some 218,000 cars were imported during the first four months of this year, or 58 per cent more than a year previous.

The Reduced Export Surplus and its Significance

As a result of the divergent movements in exports and imports, the U.S. merchandise export surplus during the first four months of the year has dwindled to an annual rate of about $1 billion. Last year, it amounted to $3.5 billion; it had run to $6 billion in 1957 and $4.7 billion in 1956.



U.S. Merchandise Trade, by Quarters, 1955-59
***April 1959 raised to quarterly basis.**

The United States is also providing "services," such as shipping and insurance, to other countries, and is receiving income from investments, well in excess of similar payments made by us. During recent years, the United States has had a surplus on "service" account of some $2 billion a year (excluding military cash outlays abroad).

As 1959 seems to be shaping up, the combined surplus on account of merchandise and services may perhaps be of the order of $3 billion. The United States thus continues to be in a strong balance-of-payments position on current account even though this year's prospective surplus is likely to be much smaller than during most of the past decade.

U.S. Balance of Payments

(In Billions of Dollars)

	Average 1951-55	1956	1957	1958	1st Qtr. 1959
Merchandise exports*	$13.4	$17.4	$19.4	$16.2	$3.8
Merchandise imports	—11.0	—12.8	—13.8	—12.9	—3.6
Trade surplus	2.4	4.6	6.1	3.3	0.2
Services rendered	5.0	6.3	7.3	7.0	1.6
Services received†	—3.5	—4.6	—5.0	—5.1	—1.2
Service acct. surplus†	1.5	1.7	2.3	1.9	0.4
Surplus on Trade and Services†	3.9	6.4	8.4	5.2	0.7
U.S. Government transfers*					
Military expenditures	—2.2	—3.0	—3.2	—3.4	—0.8
Economic grants	—2.2	—1.9	—1.8	—1.8	—0.5
Loans and credits (net)	—0.2	—0.6	—1.0	—1.0	—0.1
Subtotal	—4.6	—5.5	—6.0	—6.2	—1.4
Private capital outflows (net)	—1.1	—3.0	—3.2	—2.8	—0.4
Total government and private transfers	—5.7	—8.5	—9.2	—9.0	—1.8
Excess of transfers over surplus on trade and services	1.8	2.1	0.8	3.8	1.1
Settled by:					
Gold sales to foreigners (+)	0.2	—0.3	—0.8	2.3	0.1
Increase in foreign short-term assets	1.0	1.4	0.4	1.1	0.6
Increase in foreign long-term assets	0.2	0.4	0.3	—	0.2
Foreign capital and gold	1.5	1.5	—0.1	3.4	0.9
Unrecorded payments (errors and omissions)	0.4	0.6	0.8	0.4	0.2

*Excluding military aid programs.
†Including private remittances; excluding military expenditures abroad.

Source: U.S. Department of Commerce.

At the same time, however, the United States is supplying dollars to foreign countries in much larger amounts than they need to pay for the excess of their purchases of goods and services here over their sales. As may be seen from the table, U.S. Government transfers abroad — direct military expenditures, economic grants, and loans — are running, according to present indications, at an annual rate of $5.5 billion, as against $6 billion in 1957 and 1958. Private capital outflow, on the other hand, seems likely to be much less this year — possibly not much beyond $1 billion, as compared with $3 billion in each of the preceding two years. The reason for this is partly a slowing in direct investments abroad and partly a smaller volume of capital issues in the New York market. Despite the fall in private capital outflow, however, the over-all deficit seems headed this year toward another total in excess of $3 billion, which would be added to foreign nations' gold and dollar holdings.

There is, of course, nothing new in an over-all deficit since foreign countries have acquired dollars through their net transactions with the United States every year since 1950, with the exception of 1957. But the rate at which they have been gaining dollars has accelerated. During the eight years from the beginning of 1950 through the end of 1957, foreign nations had obtained $10.3 billion; now, as already noted, the rate is beyond $3 billion a year.

No nation is so rich that it can run indefinitely balance-of-payment deficits of $2 and 3 billion a year. At some point, foreign countries would become worried over the cumulative rise in U.S. short-term indebtedness and make increased demands upon our Treasury for gold, which in turn might lead to sharp retrenchment in U.S. overseas commitments. To allow the situation to develop to a crisis stage would be damaging not only to American prestige but to the financial stability of the entire Free World. Much more is involved than dollars and cents: the acceptability of the dollar as a substitute for gold. It is necessary, therefore, to keep our balance of payments under close study.

What to Do About the Payments Deficit

To reduce the deficit in the U.S. balance of payments, it is not desirable to restrict merchandise imports. Some two thirds of U.S. imports consist of materials and foodstuffs that are not available from domestic sources or supplement inadequate domestic production. The remainder includes finished manufactures that add to the economic well-being of the American people by increasing the range and variety of products available to the consumer. Imports of all kinds enable foreign nations to earn dollars with which to buy American goods and to service their debts. We can best strengthen the solidarity of the Free World by supporting active international trade. As the world's leading international trader, we have the most to lose from restrictionism.

The real question is what can be done, under a liberal trade policy, to strengthen the U.S. balance-of-payments position? Apart from sales to us of goods and services, government transfers are by far the largest and the most conspicuous source of dollars to foreign nations. They are broadly of two kinds — military expenditures and economic aid, whether grants or loans.

Our military expenditures abroad are motivated by the facts of life in a divided world and by overwhelming considerations of national security. It is essential that we maintain adequate military establishments abroad. A large portion of U.S. outlays for military supplies and services goes, however, to nations that have become much stronger economically and financially and are now in a position to bear a growing share of the mutual burden. Some of our cash outlays abroad could undoubtedly be reduced even though the aggregate may still remain sizable for the foreseeable future.

Our foreign aid expenditures are also motivated basically by reasons of our own national security. We have actually achieved many of the things that the Marshall Plan and its successors were designed to do: to help restore and increase the economic strength of the Free World. Economic aid, of course, weighs heavily in our budget; and, undoubtedly, available funds could often be used more efficiently. Furthermore, it should be possible to lighten our budgetary burden now that Western Europe has reequipped its industry, put its financial house in order, and rebuilt functioning capital markets. A reduction in our economic aid, of course, would not help our balance of payments to an equal extent. Much of our aid is directly linked with exports. For example, agricultural exports have been swollen beyond normal dimensions by the Public Law 480 farm surplus disposal program. A reduction in economic aid would often lead to a corresponding drop in exports.

This year, government loans, on a net basis, are running somewhat lower than in the preceding two years, as already noted. The reason for this is that Germany made sizable prepayments on its postwar indebtedness. Debt repayment in advance of maturity is thus another way of reducing the balance-of-payments deficit.

A further source of dollars to foreign countries is the outflow of private U.S. capital, which is also running lower this year than in 1957-58. American policy has been to encourage private capital outflow, particularly equity capital where "know-how" goes with the capital. This relieves development loan burdens on the U.S. Treasury, directly enlarges production abroad, and gives rise to profit remittances as a support to the balance of payments for the long future.

Reliance on the U.S. capital market for debt financing can be — and is being — reduced. This comes about naturally from the pressure on our market at a time when European capital markets are more receptive to new issues. It has been possible for the World Bank, for example, to float bonds in Switzerland, Germany, Holland and Belgium at rates comparable to or lower than the rates prevailing in the New York market. With their strengthened reserve positions, central banks in these countries, and in the United Kingdom, France and Italy as well, have been able to maintain comparatively easy money conditions.

The sensible solution to the overstrain on our capital market is to rebalance the budget. This would at the same time relieve inflationary pressures, restrain import demands, and generally help to reduce the balance-of-payments deficit.

Domestic inflationary pressures become most clearly manifest in export competitive power.

Influences on Exports

Much of the recent decline in U.S. exports can be traced to special circumstances, to the business recession in Western Europe, Canada, and Japan, and to the reduction in export earnings of the primary-producing countries. Economic recovery abroad should naturally bring about increased demand for imports from the United States.

Furthermore, the chance for U.S. producers and exporters to compete in world markets has been strengthened as the currencies of Western Europe and of their respective overseas currency areas have become more nearly convertible and as discriminatory trade restrictions on imports from the United States have been relaxed. It is now possible, as a rule, to import freely into Western European countries from the United States industrial materials, basic foodstuffs, and many types of capital goods. Controls over consumer goods have also been relaxed in a number of countries — including, last month, the United Kingdom. Nevertheless, there remains in Western European countries a varying range of discriminatory restrictions against dollar goods. Even though dollar quotas for products like passenger cars have been raised, protective tariffs are often so high as to keep our goods out.

In justice to the liberality of our import policy, barriers to and discrimination against U.S. goods need to be lowered. The excuse of dollar shortage, in any over-all sense, no longer exists. More generally, liberality of import policy by countries in strengthened reserve positions can not only add to the variety of goods available to their citizens but also aid nations everywhere suffering balance-of-payments strain.

But no one can assure foreign markets to nations that indulge in uncontrolled wage-price spirals. That is the lesson Europe learned and we need to remember. It is for this reason that the issues at stake in the current steel negotiations are assuming a crucial — and symbolic — significance. Only unequivocal arrest of wage-cost inflation can safeguard the U.S. competitive position and the confidence of the world at large in the dollar.

As President Eisenhower stressed in a recent address at St. John's College in Annapolis:

> Our whole position in world economic affairs is determined by the health of our economy and the soundness of our money. If we should neglect these at home we could soon become powerless abroad — our prosperity, our security, our freedom could be in jeopardy.

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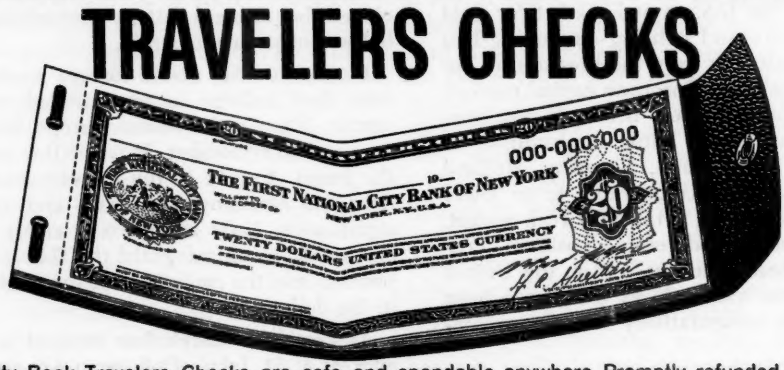

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